

APPENDIX A

VOD: Satellite Killer or Bundle Filler?

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At first blush, video on demand should be an ace in the hole for cable operators. It's a product satellite providers can't offer, which should give MSOs an edge in the cutthroat race to snare customers. But VOD may not be as potent a competitive tool as it's been made out to be, according to several experts and even some operators, who feel the product will not draw droves of new customers on its own, though it nicely complements a suite of services.

There's no question that VOD is becoming more available and, with significant marketing, usage will continue to climb. In Philadelphia, where Comcast rolled out VOD a year ago with much fanfare, half of the MSO's digital customers access VOD-both free and paid-an average of 15 times a month. The product has been such a hit that Comcast now wants to expand the business. In rationalizing the company's brash bid for Disney last month, Comcast Cable president Steve Burke said Disney's library significantly would propel Comcast's VOD and high-speed Internet products into consumers' homes.

In a similar quest to put consumers in command of their viewing experience, DBS providers are offering digital video recorders. VOD and DVRs are now at the heart of the ferocious battle between cable and satellite to keep and/or gain customers; VOD is available to more than 12 million digital cable customers, while more than 3 million DVRs have been deployed, mostly to DBS customers. Cable operators have complicated the issue for themselves-and for potential customers-by hedging their bets and deploying both VOD and DVR boxes.

"The key for operators is whether they can effectively market both products without confusing the overall message they want to send," says Leichtman Research Group president Bruce Leichtman. "It's going to be tricky."

Not too long ago, many experts considered VOD a killer application that would help woo customers from satellite. But unresolved issues abound, from paltry movie buy rates, to little consensus on what the best economic model is, to the hesitation on the part of studios to shorten release windows and provide content.

Of all the problems associated with VOD, the delayed release windows and lack of content are perhaps the most frustrating for operators because they have no control over them. Delayed windows helped prevent pay-per-view from taking off, and it is hampering VOD growth as well. A Comcast/Disney deal might go a long way toward breaking that stalemate, says Merrill Lynch analyst Jessica Reif Cohen. As she pointed out in a recent research note, "Comcast, when combined with Disney, would be able to quickly improve the status of the VOD window, at least for the Disney theatrical product."

Fighting a Customer-Friendly Technology

But how effective will cable's VOD offering be against DBS' DVR pitch?

"DVRs have a bigger impact on a consumer's viewing habits than VOD, even though VOD is in more TV households right now," says Josh Bernoff, a senior analyst with the Forrester Group. Bernoff believes VOD isn't powerful enough to go toe-to-toe with DVRs. "It's one of the reasons all of the major MSOs made serious inroads in launching DVRs in the last year."

Simply put, DVRs are videocassette recorders on steroids. The technology is easy for consumers to understand because it's not that far removed from the VCR. Consumers have 30 years of experience playing with and figuring out how to use VCRs, which introduced them to the concept of time-shifting their favorite shows.

VOD, on the other hand, is a new animal of sorts. The technology has been around since the early 1990s, and was popular with Time Warner Cable consumers in Orlando during the MSO's full-service network experiment. But cable plant, for the most part, was unable to handle the newfangled, two-way service, and it was expensive to deliver, so the product hung in limbo for almost a decade while operators upgraded their networks.

Satellite distributors soon began hyping DVRs, and cable has, in essence, been playing catch-up with VOD ever since. About half of all respondents in a recent CTAM survey said they were familiar with VOD; and 74% of digital customers said they were familiar with VOD. Only 22% of all cable customers aware of VOD and who reported having it available to them have ever ordered anything. Extrapolating that percentage across the entire VOD-ready universe translates into 2.64 million homes using VOD-not a heartening figure when taking into account the 3 million customers who have DVRs.

Simplifying the Medium and the Message

The industry's timid marketing approach also has prevented VOD from taking root with consumers. Smart marketing boosts VOD, as Cox proved in its San Diego market.

Cox blitzed San Diego last June with a sweepstakes that drove customers to the MSO's VOD interface site. Once there, they could browse and experiment with the product. VOD movie buy rates skyrocketed 70% over the previous month's totals. And the numbers remained high the month after the promotion ended, says Denise Myers, manager, PPV/VOD, for Cox.

VOD can't serve as an effective competitive tool unless it's pushed to the front of the marketing pack, says Horowitz Associates president Howard Horowitz, noting the product is in a classic chicken-and-egg situation. VOD won't be ready for prime time until there is a mass of customers subscribing to it and using it. But unless operators market it, the product will never reach the mass audience it needs to be successful.

Bruce Leichtman concurs. "Soft launches of this product simply don't work," he says. "Operators need a robust product they're willing to heavily promote. That will result in higher usage and something that people will talk about. If they don't do that, VOD isn't going to do anything for them."

Almost 8 million Comcast digital customers had access to VOD at the end of 2003. Each month, the company boasts about 4 million VOD transactions - both free and pay - which translates into a 50% penetration rate. Digital customers in Philadelphia access their VOD options more than a dozen times a month, which suggests that the bulk of the buys are being conducted in the market where the service has been hyped the most and the longest.

"In the midst of the industry's deployment of on demand, we forget it is a brand-new product to consumers," says Char Beales, CTAM's president.

One of the biggest challenges in selling VOD is making sure a customer's first experience goes smoothly. "In the past," Leichtman says, "operators were afraid to market VOD because they weren't sure it wouldn't fail."

The technology has improved, but the product remains clunky. The navigation interfaces are frightfully user-unfriendly. Customers often must click several buttons on their remote control to even get to the VOD navigator, and it's often unclear whether the customers are accessing free or paid content. The whole experience can leave a customer weary.

A CTAM consortium of operators and vendors is working to debug VOD interface and navigation systems. The group plans to release a set of "best practices" during its digital research conference this month.

The set-top box and guide providers also are working overtime to improve cumbersome VOD interfaces. Pioneer Digital Technologies introduced a new VOD venue application in Time Warner Cable's Los Angeles market last month in which customers hit one "hot button" on their remote to access the VOD application.

"We're starting to eliminate the click-through fear factor that has hampered VOD," says Pioneer SVP Neil Ward.

Awkward navigators aside, Comcast saw its VOD usage double last year, says Page Thompson, VP, marketing, new video products. Comcast's addition of free VOD content, coupled with the fact that "they're promoting the hell out of it," is making an impact on usage, says Forrester's Bernoff. The numbers are so encouraging that Comcast will make VOD available to 80% of its customers by year's end.

Comcast, like all operators, also is getting as many DVRs into customer's hands as possible. "But [DVRs are] only half the equation," Thompson says. "DVRs are a great tool for folks who want to make the effort to tape shows. But VOD works better for the way most people watch TV. They browse, click and watch. You can't do that with DVRs."

Starz has found that in markets where SVOD is marketed aggressively, more cable customers sign up for its premium channels. Consumers need some hand-holding up front to understand how the product works, says Greg de Prez, VP, SVOD division. In markets where Starz On Demand becomes available, the company calls customers in and walks them through the process of ordering SVOD programming. Once they get over their fear of trying it, he says, they tend to love it.

Cox has come to the same conclusion. "We learned that if customers figure out how to use VOD, they do," Myers says.

Try It, You'll Like It

One of the industry's biggest challenges with SVOD and free VOD is helping customers understand that they won't be charged each time they access a show.

"It's going to take some time-probably 12 to 24 months-before people learn how to use the product and get used to it," says Yankee Group's Michael Goodman. "VOD and SVOD have the potential to be powerful competitive tools, but they're not today. Not enough people have access to it and not enough people know about it. This is a product that requires a lot of consumer education, and that's only now starting to occur."

Enticing consumers to try VOD also requires offering content they really want to see. "People talk about how much DVRs change the way they watch TV," says Robert Ladd, PPV/VOD marketing director, Charter. "But we are also hearing a lot of people say that they watch a lot more VOD/SVOD programming than linear television now, which tells us a lot."

Ladd believes VOD is a valuable service, but also says the product's full potential hasn't been realized because it hasn't been marketed aggressively enough. That's clearly the case at Charter, which curtailed its marketing efforts for all products in the first half of 2003. While the decision helped keep costs low, it also impacted the MSO's year-end results.

Charter's VOD service was available in 4.48 million homes at the end of 2003 versus 3.95 million at the end of 2002. However, revenue per digital customer remained essentially flat at \$23.11 a month versus \$23.41 in 2002. The availability of VOD may have helped Charter add digital customers during the period, but it didn't keep analog customers from defecting. The MSO lost 41,300 customers during the fourth quarter.

"VOD as a concept is a lot like HD," Ladd says. "Once you see it and try it, you love it. But you have to get past that first hurdle before it will take off."

Operators are aiming most of their VOD marketing at existing digital customers, so it's little wonder that it's not a big lure for DBS customers. Leichtman Research Group found last year that less than 30% of satellite customers even knew what VOD was. It can't be used to lure DBS customers if they don't know it exists, Leichtman says.

DBS Rolls the Dice

While VOD usage is growing in markets where the service is heavily marketed, it may be a better retention tool than an acquisition device. VOD is a key ingredient in the mix operators are using to retain digital customers, says David Pugliese, VP, product marketing/management, Cox.

"VOD is just one arrow in cable's quiver," says Ted Henderson, an analyst with Stifel Nicolaus. "If you were comparing video to video, it would be difficult to choose which service-VOD or DVR-is better. But operators aren't just selling one product anymore-or they shouldn't be. It's more than just video for them. That's their advantage. The bundle is the killer app, not just one product in the bundle."

Cox, the industry's bundling baron, couldn't agree more. Over 2 million customers, or nearly 36% of its basic video customers, subscribe to at least two of its voice, video and data services. The MSO has launched a paid VOD movie service in four of its markets, and plans to offer the product in four more markets by midyear.

"VOD is a great differentiating tool against DBS, but to what extent? We don't have enough quantitative data to say just yet," Pugliese says. "You can look at VOD two ways-as a retention vehicle and as a revenue-generating business. For us, it's not one or the other."

DBS providers aren't taking any chances. Both EchoStar and DirecTV are broadly promoting DVRs to their customers. EchoStar spokesman Steve Caulk says Dish Network, which boasts over 1 million DVR boxes in the field, can't keep its DVR set-tops in stock. And a new high-definition DVR box, despite its hefty \$1,000 price tag, is flying off the shelves. Likewise, DirecTV, which News Corp. took control of late last year, is aggressively publicizing and tweaking its DVR offerings to appeal to consumers.

With the number of DVRs expected to grow to more than 37 million by 2007, VOD stands to be outstripped if marketing efforts slip. Satellite operators are making big bets and spending big dollars to sell DVRs. Flashy promotions are prominently displayed on both DirecTV's and Dish Network's websites. DVR marketing materials and ad campaigns abound in any number of media and retail outlets.

The DBS providers are also underwriting the cost of the DVR boxes to push the units into customers' homes. DirecTV added 405,000 net new customers in the fourth quarter, in large part due to its DVR offerings. The strategy edged up already pricey customer acquisition costs, which didn't please investors. But it's also helping add customers and reduce churn, a trend investors like seeing.

Not surprisingly, the DBS providers say they're not worried about VOD. But DVRs have their drawbacks as well. The technology is great for those customers who are organized enough to program their boxes before a show is televised. VOD, on the other hand, is a useful tool for grazing and spontaneous viewing. Moreover, operators are crafting exclusive VOD programming DBS customers can't and won't have access to.

"Cable has programming we don't have, and we have programming they don't have," says Caulk. "We think DVRs are setting the stage for the way Americans will watch TV in the future. It gives them total control over what they want, when they want it. I wouldn't say VOD programming is superior to what you can get with a satellite subscription."

If and when more content becomes available, exclusive or not, that may change. For now though, Bernoff says, "Anyone who thinks they can take on DBS with VOD will be mistaken."

—With Mavis Scanlon

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APPENDIX B



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Video May Kill Satellite's Star

Dustin Goot 12.06.02

ANAHEIM, California -- Broadband Plus, formerly the Western Cable Show, opened this week with a call to arms from the chairman of the California Cable and Telecommunications Association: Cable companies must "stop the bleeding that's going to DBS (satellite)."

The CCTA chairman, William Rosenthal, introduced Comcast CEO Brian Roberts, who made clear that he viewed video on demand, or VOD, to be the industry's weapon of choice in this battle.

"VOD is a 'wow!'" Roberts said, declaring that a consumer's initial video-on-demand experience is comparable to the first time someone uses a wireless phone.

In November, Comcast launched a VOD service to over 500,000 Philadelphia-area subscribers, joining Time Warner Cable, InSight Communications, Charter Communications and others in aggressively rolling out the technology in their markets.

Video on demand is attractive to cable operators because it requires a fast two-way communication between the set-top box and the central broadcasting plant, which digital cable infrastructure can provide. Satellite, meanwhile, is designed to flow in one direction and lacks an adequate upstream connection. (To communicate with the satellite plant, users have to plug into a phone line.)

Roberts said VOD would allow cable companies to regain their status as television's technology innovators, a distinction he said they have lost to satellite providers.

From all indications at the show, broadcasters are more than ready to unleash VOD.

"We are embracing this," said Fox Cable Networks' Lindsay Gardner, speaking at a VOD breakout session where an overflow crowd stood three rows deep in the back of the room. "We see VOD as more than a nifty tool or even a killer app ... it's part of a power shift (to the user)."

Similarly bullish attitudes dominated a panel discussion with cable programmers before the general session. John Sie, founder of the Starz Encore Group, said "cable has a window of opportunity" to build momentum behind VOD and gain a competitive advantage over satellite.

Sie anticipated that satellite might not be the only business to come under attack from VOD. He said video rental outfits like Blockbuster might suffer, and noted that the amount people spend on renting movies is "money that can be back in cable's pocket."

In an interview, Blockbuster spokesman Randy Hargrove dismissed this scenario. "We certainly do not feel threatened by VOD.... It's always been five years away," Hargrove said.

But according to Andy Addis, Comcast's vice president of marketing, within two years cable's VOD business "will begin to tap into the home video rental market in a pretty significant way."

Addis also said the release windows for home video and video on demand would become aligned. Currently, movies are released to video stores about 45 to 50 days before they become accessible on VOD.

Still, some cable executives worried that video on demand could cause some unforeseen casualties.

"If subscription VOD just becomes a bunch of transactions on a bad interface, do you lose that connection to the (network) brand?" wondered Showtime CEO Matt Blank.

Elsewhere at the show, Lynne Elander of Cox Communications warned: "We're not going to change the

economics of television by making on demand available. We need to make on demand a win for advertisers."

Meanwhile, in response to a query about how VOD might change television, Roberts said: "We try not to answer those questions." Instead, he said, the cable industry should take its best shot against satellite and let consumers decide the rest.

For Roberts, and many others, that shot is video on demand.